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TRUST SHARES FOR YOUR ATTENTION

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TROUBLED TRUSTS RAISE TROUBLING QUESTIONS

A subscriber questioned the equitability of *Continental Mortgage Investors'* adviser deriving a higher fee in the December quarter while earnings were below the year before. We dealt with advisory compensation in RTR July 12, 1971 when it was pointed out compensation based solely on assets conflicted with the interests of shareholders. The adviser's inherent incentive is to increase the asset base via leveraging. When the spread declines, total earnings may decline even on a larger asset base. Shareholders may still be obtaining greater earnings than if assets were unleveraged but the inequity of less efficient leveraging at the shareholders' expense remains. We do not know a perfect solution but performance fees coming on top of smaller asset management fees might partially redress such imbalances.....Also throwing off sparks which raise questioning eyebrows is *First Mortgage Investors*. Its yearend report included \$2.5 million from real estate capital gains. This equaled \$0.42 an average share, accounting for one-sixth of the reported \$2.40 primary earnings. The portion coming in the fourth quarter was \$0.27 after the third quarter foreclosure gain equal to \$0.15. Subtracting from the reported numbers, this would mean about \$0.34 from operations in the final quarter although the trust feels the actual operating figure was over \$0.40. Not all the fourth quarter gains were foreclosures, some were cashed equity investments. Two were for cash and one for mortgages. Some analysts complain they did not learn of foreclosures, however, until taken as profits. Dividends were flat through the year, \$0.56 in the last three quarters after \$0.55 in the first. The trust in turn questions concern given to the definition of operating earnings. Commitment fees for example have long been taken into earnings. There is a difference, however, in the recurring nature of such fees compared with real estate sales. Back on the operating front, FMI's April quarter looks higher than January with fewer extraordinary gains likely.

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LAND TRUSTS PIONEERING IN HIGHLY LEVERAGED SECONDARY FINANCING

Perhaps no category of new generation realty trusts has so captured the fancy of investors as the land trusts. *Cabot, Cabot & Forbes Land Trust* was first of this new breed to come public, and its shares have now risen from an offering price of 20 on April 2, 1971 to current quotes about 28½. But while investors have focused on the glamorous aspects of land trusts, smaller amounts of attention have been given to the potential risks in this relatively new class of investments.

The land trusts specialize in subordinated land purchase and leasebacks, or subordinated fee ownership. This means the trusts own the land beneath major income properties such as office buildings, shopping centers and apartment complexes. In the typical transaction, the land is leased to the builder-developer of the project who continues to own and operate the structure.

But there are numerous variations with deals being structured to give depreciation to investors who can use this tax shelter. And since depreciation is one of the major surplussage items in real estate (see RTR, Feb. 14), any deal which captures the value of this wasted asset is worth doing all around. As the table below shows, there are four possible layers of interest in a major income property under today's new financing techniques. And while all four layers are not found in every property, the table shows the strategic position in the hierarchy occupied by the land trusts:

LAYERS OF INTEREST IN AN INCOME PROPERTY		
Interest	Secured by	Depreciation
First Mortgage	- First lien on building and other improvements	None
Land title	- Owns land subject to first mtg. but before equity	None
Building equity	- Owns building subject to both of above	All
Operating leasehold	- Holds right to rent and manage property	None

In this evolving hierarchy, the land trusts hold a position about half-way between the first mortgage holder and the equity owner. In essence they are preferred equity owners, although their position is similar to that of the familiar second mortgage holder.

There are several major distinctions between the land owning trust and a second mortgage holder, however. Second mortgages typically carry high interest rates and are for short terms. Because they must be repaid in a few years, their repayment terms are generally onerous and may even imperil project cash flow. The land leaseholds are exactly the opposite: they are for very long terms, 30 to 70 years normally, and are never amortized. The annual leasehold is typically an interest rate on the land purchase price and currently is in the 10%-11% range--or about 2% above the going rate for prime long-term mortgage money.

For this reason the land trusts say they have succeeded in institutionalizing secondary financing. They have succeeded in restructuring the terms of the typical second mortgage in such fashion as to make the land leasehold a respected tool of real estate finance. And two of the three major land trusts began their lives as private trusts whose shares had been placed with major pension funds and other institutional investors, indicating acceptability by major investors.

Another strong point is the long-term nature of the investments. Funds are typically invested for 30 to 70 years, and hence the trusts escape the tread-mill effect of having to reinvest a continuing rollover of short-term mortgage loans. For this reason their income is more stable and more easily projected.

There are five major aspects of land trusts that should be examined by investors: the true leverage of the land positions, the leveraged inflation hedge opportunities, the joint venturing or equity partnership aspects, the control over sour investments, and the creativity of the trust managements themselves.

1. True leverage. The land trusts are among the highest leveraged trusts operating today, yet few investors searching for leverage among the ranks of the mortgage trusts recognize the leverage which exists in this group. This is so because the land trusts nearly always invest their funds in a position subordinated to a prior first mortgage. And since this first mortgage may be about 75% of appraised value, the land trust buying land equal to 10%-15% of the property places itself in a position of enormous leverage potential. The table below makes this clear, with dollars in millions:

THE LEVERAGE PICTURE IN LAND TRUSTS

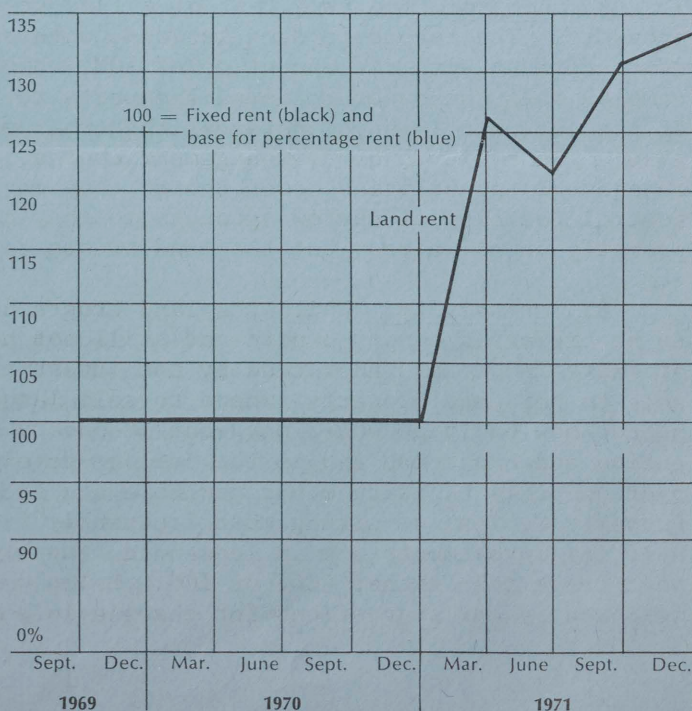
Trust	Date	Land & 2nd mtgs.	Prior mtg. debt	Debt leverage	Trust leverage in capital	True leverage*
Cabot, Cabot & Forbes	Nov.'71	\$49.31	\$ E221.9	4.5-1	0.00-1	4.5-1
ICM Realty	Nov.'71	32.28	151.5	4.7-1	0.13-1	5.3-1
Property Capital Tr.+	July'71	25.04	120.5	4.8-1	0.65-1	7.9-1

*Product of debt leverage times capital structure leverage plus one. The same result is obtained by dividing debt leverage by the percentage of equity in a trust's total capital. Data do not include \$25 million private placement by Cabot, Cabot & Forbes in December 1971. + July 1971 used for illustration. See text for current data.

That leveraged investment position is further magnified by the leverage some land trusts have built into their own capital structures. To the extent that borrowed funds support their equity investments, they are applying leverage to leverage. In the table above we have shown this true leverage as a multiplicative impact, in accordance with general rules of statistics. We recognize that in practice land trusts may be allocating their borrowed capital against unleveraged investments, but the tabulation above presents a truer picture, in our opinion. The question is whether the land trusts are exposed to risks far higher than most investors can tolerate. We believe not. Generally the preferred equity income stream from land leaseholds is of such quality that it affords an excellent way of using maximum leverage with minimum risk.

2. Leveraged inflation hedge. By virtue of their preferred equity position, the trusts have generally sought percentages of gross rentals over base amounts as additional interest. CC&F normally receives 15% of rent increases above the base, while ICM Realty generally gets 30%-35% of these overages. Since the land trust's ownership position is itself leveraged, this means that even small increases in rental payments can alter yield dramatically.

How ICM Realty's Income Grows Through Percentage Rent.



For instance, ICM Realty shows an example of how rent increases at its Glendale Lake apartment project outside Washington, D. C. affected return. By the fourth quarter of 1971, the rentals were running 10% above the base amount but the overages had increased land rent by 33% over the basic 10% return on the trust's \$900,000 investment. At that level the investment had an annualized 13.3% return (see graph, p. 3).

However it is possible to become swept away with such illustrations and the Glendale Lake example is admittedly a dramatic one. At the end of its fiscal year last November, only eight of ICM's 47 investments were producing overages. This is consistent with the fact that none of ICM's investments were over three years old and overages normally do not contribute to return during a project's early years. In fact, initial rent schedules sometimes must be scaled back in soft markets and so rents may not attain the base for three to five years. For this reason we believe residential rent controls are a minor factor in determining the long-term impact of overage clauses for apartments. Non-residential rents are uncontrolled.

The trusts also provide inflation hedges by generally asking and receiving a share in any proceeds from refinancing the first mortgage. ICM generally seeks 15% to 35% of refinancing proceeds, CC&F 10%-15%. In fiscal 1971, refinancing proceeds provided about \$114,362 (or \$0.07 per share) to ICM's net income. CC&F however will not approve refinancings unless the net cash flow after refinancing will provide from 125% to 175% coverage of the ground rent.

3. Equity partnerships. The land trusts are ideally suited for pre-development financing, even though the land sale and leaseback is normally conceived as a transaction effected after a project has been completed. To varying degrees all three land trusts use land purchases to provide front-end financing for developers. For instance, the trust may agree to buy land at its raw-land value and then convert this investment to a higher-value land purchase when the building is done and rented. Or the trust may make a land acquisition loan convertible into the land position later. There are numerous combinations possible. Property Capital, for instance, views itself as an equity partner in development situations while the other two trusts give less emphasis to this use of land leases.

4. Control. The true test of a land trust comes when properties fall under pressure. The record to date is good, with all three land trusts reporting investments current with the exception of ICM, which acquired a Memphis, Tenn. apartment complex when the owner conveyed the units to the trust. The units are 100% occupied at present, but in such instances the trust must be fully prepared to step in and assume the equity owner's management chores. This is why the trusts generally have management capabilities, even though they may be little used. Some land lenders control the flow of escrow accounts so they can be sure the first mortgage is paid promptly at all times, but the land trusts do not generally operate in this manner.

5. Creativity. While the land trusts hold the enviable position of being able to be preferred equity owners and still not have depreciation--i.e., all income is ordinary income as understood by the investment community--they sometimes are not able to persuade property owners to sell land to the trust. This is so because no matter how badly an owner may want secondary financing, the sale is a taxable transaction and hence may expose the builder-developer to extra taxes. The trusts have overcome this by using other purchase and secondary mortgage loan vehicles, with Property Capital departing most frequently from the land ownership format. About half its investments are in leasehold, junior and wrap-around loans, a much higher percentage than either CC&F or ICM. Below we review the three land trusts briefly followed by our suggestions for changes in our equity trust portfolio.

Cabot, Cabot & Forbes Land Trust (28 3/4-ASE) is the youngest of the trio but not lacking in depth or experience. Its parentage, Cabot, Cabot & Forbes, has long been a successful industrial developer with prominent associations. Parent CC&F holds for its own account property having gross value of \$300 million. Moreover, the trust has added to inherited capabilities by adding several trustees whose background is financial stemming from money management while hiring younger generation advisory staff with an aggressive bent. This combination of diverse talents is headed by several outstanding men with long, distinguished experience. Gordon Emerson Jr., the managing trustee, is largely credited with popularizing the subordinated land purchase and leaseback technique while an executive of John Hancock Life Insurance Co. He is a well established deal maker and the crux of success and growth here is the ability to make the deal fair for both parties. Gerald Blakeley, chairman of the adviser, is a long proven developer. Paul Hellmuth, president of the adviser, has varied background including securities stock investment.

Thus, CC&F Land Trust's distinctive features appear to be strong developer orientation aggressively implemented. Growth has been rapid since the \$60 million initial offering of April 2, 1971. Even after allowing for the impetus of the parent providing \$11.9 million in properties, the pace has been impressive to reach \$63-4 million in land purchase and related development investments. Another facet is the stress upon making of construction and development loans when the trust is interested in the permanent, participating follow-on.

Progress has been sharp since the first full quarter (August, 1971) when net was \$0.38 per share diluted. Profit was \$0.50 in the third quarter ended January. This was slightly below earlier expectations but did not reflect operating impairment. The rate of closings was somewhat less than expected. As the equity trusts generally have grown, placements have become a bit more difficult. CC&F has been moving away from the major cities to the still robust but smaller cities. Many clients here are less sophisticated to the trust's technique and required some time consuming education. Additionally, there appears to have been some seasonal interference with business schedules during the year-end holidays but the flow has since picked up.

Yields have softened somewhat for land purchase-leasebacks but remain much in line with long-term money trends and much less volatile than short-term loans. As of November, 1971, the \$49 million portfolio yielded 10.92% and dropped only to 10.86% on the \$63 million out currently. The deals added were mainly those already in pipeline. New deals today, however, are being written at 10 1/4-3/4%, mostly the lower range, while previously they were being done at 10 3/4-11 1/4%. More significant to long-term prospects is the fact that participation percentages have not been lowered. Variable rent based on gross revenues is seen adding 200-350 basis points to yield over 15 years (13-25 BP annually).

The portfolio breakdown remains 73% land purchase-leaseback and 27% development. The property mix is 42% multi-family residential, 29% office buildings, 16% shopping centers, 6% hotels and 7% industrial. Prospects are restricted in the residential category by Phase II limitations on rents. Like everyone else, CC&F would like to move more into other categories but will not forego opportunities here. The impact of restraints on residential rents makes the trust reluctant to lower its initial yields on these properties. Shopping centers are the most desirable property type even though the most complex but as the most sought after real estate type they carry the lowest yield. The trust would like to increase its industrial segment. Here, the interest would be for appropriate leasing structures with more developers going to 1-5 year leases. This would permit the rollover necessary to provide attractive participations.

By age, the portfolio mix is 60-40% old to new properties. The trust would prefer to increase the older segment where original and carrying costs are lower than for new properties but the opportunities lend themselves more often to new real estate which is easier to penetrate as the deals are being drawn up.

In December, 1971, the trust arranged for \$25 million in 15-year, 8% debentures with 300,000 warrants attached exercisable at \$28 for ten years. The equity portion would amount to 33% of the debt. While not everything desired in maximizing debt leverage, this rare use of straight debt will permit a return over coupon to shareholders and the use of warrants appears fairly judicious. The last of this debt is to be taken down in June, 1972 but the trust will require more long-term or equity financing this summer. The form will depend on market conditions but a variation of the above is appealing.

Third quarter earnings were at the annualized rate of \$2.00 per share diluted but we can accept the current quarter's estimate of \$0.54 with high confidence. The shares are thus selling for about 13 times current annualized earnings of \$2.16. They remain reasonably valued despite the runup over recent months and may be purchased by those who do not yet have a position per our portfolio recommendation.

Property Capital Trust (21 1/2-OTC-Symbol PROPS) is nearing the end of its third year of operations. PCT began life with a private placement at the end of 1968, but the trust's funds were not received and its investment program did not begin until July 1969. Major initial investors in PCT included Morgan Guaranty Trust Co. on behalf of pension trusts, Connecticut General Life Insurance Co., the General Electric Pension Fund, and other institutional investors. Last July PCT offered 750,000 new shares to the public at \$21 to complete the transition from private to public trust.

PCT views itself as an equity partnership trust which has helped institutionalize subordinate, or secondary, financing. Management however is not committed to turning every proposal into a subordinated land purchase but strives to structure its investments in whatever form best suits the property and the equity partner.

Thus the portfolio is quite different from that of the other two land trusts. As of Jan. 31, about 45.6% (or \$23.79 million) of its gross investments of \$52.16 million was in land leaseholds and another 30.8% (or \$16.05 million) in long-term mortgage loans which were wrap-around loans, junior loans, and first leasehold loans. About 23.6% (or \$12.33 million) is invested in short-term mortgages, including a \$9 million blanket junior mortgage in the Greenway Plaza high-rise office complex along the Southwest Freeway in Houston.

PCT deals mainly with major developers capable of creating and sustaining large developments. In addition to Greenway Plaza, the trust has investments in such well-known projects as Northland Point Office Park in Southfield, Mich., Capitol Park Apartments in Washington, Wellesley Office Park in Wellesley, Mass., and Queen Kapiolani Hotel in Honolulu. At the end of its fiscal year last July, about 46% of investments were in office buildings and office parks, 32% in apartments, and 22% in shopping centers and industrial parks.

PCT investments range from the simple subordinated land purchase and leasebacks to very sophisticated deals. In one instance, for example, the trust advanced funds that helped two Cleveland investors make a successful tender offer for buildings held by a small realty trusts, Shaker Trust. In another, PCT structured a \$500,000 convertible wraparound loan beneath a \$5 million permanent mortgage. The wraparound is structured as a 10-year standing loan that in effect lets the owner

STATISTICAL COMPARISON OF THREE LAND TRUSTS

Trust	Fiscal	Book Val.	-Latest quar.#-			Recent	P/E	Div.
	year	Share	Mon.	EPS	Div.	price	ratio	yield
Cabot, C&F Land	May	\$19.80	Jan.	\$2.00	\$2.00	\$28.75	14.3	5.7
ICM Realty	Nov.	20.35	Nov.	2.00	\$1.60	23.88	11.9	6.7
Property Capital	July	13.75	Jan.	1.48	1.36	21.50	14.5	6.3

E-Estimated declaration for February 1972 quarter. # Annualized.

claim use of the depreciation tax shelter for 10 years. The Greenway Plaza loan is unusual for its interest terms, a range of 8% to 10% depending upon the prime rate, and the fact that the trust has an option to "put" the loan to Fidelity Mutual Life Insurance Co. anytime after March 1, 1973. Thus the trust's investment is not dependent upon either the developer's success in renting or his obtaining of permanent funding.

In each deal the trust has dealt with recognized and capable developers who are experienced both in the product proposed and have financial strength. The property must be rated prime by the trust. In its stance as an equity partner, the trust still will not invest in deals until completion. When the trust advances funds during construction, the developer must supply a letter of credit. The trust does not want to assume a construction risk, and is not interested in becoming a developer. It is interested in backing good developers, however. As a result portfolio yields have been well-maintained, holding at 10.88% in the January quarter vs. 11.74% in the peak quarter, April of 1971.

On the liability side, PCT is more highly leveraged than the two other land trusts, with the balance sheet at Jan. 31 showing \$8.9 million of demand notes to banks and \$18.0 million of senior 6½% notes. These latter notes resulted from PCT's original private placement and this fixed, non-convertible debt has been one reason PCT has been able to maintain an unbroken record of quarterly rises in earnings per share for 10 consecutive quarters now. While the trust might not be able to duplicate these debentures in today's market for debt securities, their presence on PCT's balance sheet imparts stability of long-term capital. Bank borrowings are under a \$21.0 million line at ¼% over the prime with normal compensating balances. Shareholders' equity of \$28.5 million is represented by 2,065,415 shares.

The trust is advised by Property Capital Advisors, Inc., which was organized simultaneously with the public offering last July. John A. Cervieri Jr., formerly with Realty Income Trust, took the lead in organizing the trust and now serves as president of the adviser and as managing trustee. Before the public offering the trust had operated through its own staff. Cervieri and three others associated with the adviser exercised options for 79,750 shares (about 3.9% of outstanding shares) granted at prices from \$12.85 to \$16.00 simultaneously with the offering, one of the relatively rare instances in which trust advisers hold a major stock interest in their trust.

Since the offering the trust has maintained its earnings growth on the higher number of shares outstanding. January quarter earnings were \$0.37 per share (\$1.48 annualized) and the dividend \$0.34 (\$1.36 annualized). Total portfolio funding has advanced steadily with a net gain of \$9.14 million for the six months through January. The gain has been financed through bank borrowings under the trust's plan of expanding portfolio in this manner until such time as additional capital raising becomes necessary. We expect the portfolio to grow at about the same rate for the next four quarters and the yields to increase slightly from current commitments. Earnings per share should advance moderately but steadily to a rate of about \$1.68

\$1.72 within that year. With a current P/E ratio of 14.5 and a dividend yield of 6.3%, the shares are richly appraised in relation to other trusts. Management however has great experience in trust operations and we believe longer-term commitments should prove rewarding. The shares will be added to our equity portfolio at the current price.

ICM Realty+(23 7/8-OTC-Symbol ICMRS) also started life as a private trust and also has only recently made its initial entry into public markets. The present ICM is the amalgamation of three separate smaller realty trusts which began operating in December, 1968, making it the oldest private trust. Initial investors were mainly pension funds managed by the trust departments of major New York City banks.

The trust is advised by Investors Central Management Corp., a company formed in 1956 by a group of large mortgage bankers to originate and service mortgages for pension funds. In this role the adviser originated and now services a portfolio of about \$375 million. ICM sought the initial IRS rulings which permits pension funds to invest in REIT shares, a key factor in the growth of REITs over the past three years.

Nearly all ICM's early investments were in land beneath apartment complexes, and at the end of its third fiscal year in November 1971, ICM held land beneath 47 apartment projects in 13 states. About 27% of land investments of \$35.37 million prior to the offering were invested in Chicago-area apartments, with other larger concentrations in the Dallas area (8.6%), Atlanta (7.8%), Houston (7.0%) and Washington, D. C. (6.5%). These prior investments covered 13,915 apartment units. These land leaseholds yielded an average 10.2% before overages, which in some instances can increase yield greatly (see p. 3-4).

In conjunction with its Dec. 22, 1971 public offering of 1,000,000 shares, ICM has enlarged its investment objectives to stress shopping centers, office-apartment complexes and two hotels. Of the \$23.65 million commitments expected to be closed by the end of March, about two-thirds (\$15.46 million) will be invested in shopping centers with the remainder split about equally between apartments (\$2.9 million), two hotels (\$2.66 million) and one office-apartment-commercial complex in the Washington area (\$2.6 million). Yield on \$18.25 million of land leaseholds is 10.6% while \$5.4 million of second mortgages is a weighted average 8.5%. When the investment program is completed, ICM will have added property type diversification to its holdings.

ICM historically has operated with very little bank borrowings, generally taking the conservative path of funding land leaseholds with equity. At the end of fiscal 1971, ICM carried \$2.6 million of bank borrowings under a \$20 million credit line at the prime rate. In addition a shopping center is owned subject to a \$3.9 million mortgage. It is possible that ICM will begin to use bank borrowings to build its portfolio in the manner of Property Capital (see above) but at present there is no assurance this will happen. Management is experienced and capable. Earnings suffered during fiscal 1971 for several non-recurring factors associated with the public offering. We expect annualized earnings to reach about \$1.80 per share in near-term quarters. One major limiting factor is the inactive trading market which has developed, a situation we expect to be remedied over time. We have already added the shares to our equity portfolio as a quality issue with major inflation hedges. With the highest yield on current prices, it is the group's best statistical value.

+Audit Investment Research employees and officers hold a minor position in these shares.

Written as of noon Thursday March 9.